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OFFICE OF
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MEMORANDUM

Implications of Emerging Economic Problems in the USSR

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18 December 1969

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C E N T R A L I N T E L L I G E N C E A G E N C Y

OFFICE OF NATIONAL ESTIMATES

18 December 1969

MEMORANDUM

SUBJECT: Implications of Emerging Economic Problems in the
USSR*

During the past three years (1967-69) the Soviet economy has kept on growing, but at a declining rate. This retardation is in large part the consequence of deficiencies in technology, management, and the system of incentives. These deficiencies have existed for some time, but have come to the fore in the last half of this decade. Their continuing existence strongly suggests that, while the Soviet system is a proven engine for generating growth at one stage of development, it is less and less able to meet the requirements for continued rapid growth in a sophisticated and complex modern economy. This is in large part because of political constraints, which preclude the adoption of the necessary reforms. The pressures for change will probably not prevail in the near future, and the period of basic adjustment, should it arrive, will be profound in its political ramifications.

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- * This memorandum was produced solely by CIA. It was prepared by the Office of National Estimates and coordinated with the Office of Economic Research, the Office of Strategic Research, and the Office of Current Intelligence.

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1. The Soviet economy today is essentially the same Stalinist model devised by the late dictator in the 1920s and perfected in the 1930s.* The emphasis has been on heavy industry, at the expense of agriculture and consumer welfare. Although Stalin's successors have improved its performance somewhat, the economy continues to be characterized by the centralized allocation of resources through administrative action, and by forced draft industrialization.

2. While the deficiencies of this model have become more apparent with the passage of time, the Kremlin still is not prepared to undertake a fundamental overhaul. Assuming that the leadership could devise an effective alternative system in the first place, the risk is that the necessary actions would require or inevitably produce unacceptable political changes -- in particular, an erosion in the predominant role of the Communist

* The term "Stalinist model" refers to what the Polish economist Lange calls "the first period of planning and management in a socialist economy...(This) has always been characterized by administrative management and administrative allocation of resources on the basis of priorities centrally established. This is...a highly politicalized economy, both with regard to the means of planning and management and the incentives it utilizes. I think that, essentially, it can be described as a sui generis war economy." O. Lange, The Political Economy of Socialism, Warsaw, 1957.

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Party. Moreover, the leadership can continue to temporize because the economy, for all of its faults, still does reasonably well in providing Moscow the wherewithal to mount and sustain the regime's most pressing programs. Chief among these is the military-space effort -- unquestionably the first priority claimant on the country's resources -- which will continue to fare well in the future.

3. Yet the leadership probably also realizes that the difference in the size of the US and Soviet economies is not narrowing, that the USSR is far from leading the international growth rate sweepstakes, and that Eastern Europe and Moscow's client states in the underdeveloped world promise to be on balance more and more of an economic burden than a bonus. There is abundant evidence that the large productivity gap between the USSR and the developed West is the most worrisome of all. The productivity of the Soviet economy, measured in output per unit of capital and labor, is only about one-third that of the US and slightly more than three-fifths that of Western Europe. This comparison, moreover, does not take into account the substantially poorer quality of most Soviet products, which places the USSR in an

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even more disadvantageous position vis-a-vis the West. The productivity gap arises largely from the poor performance of the Soviet economy in generating or absorbing advanced technology. It will keep widening if the USSR fails to participate fully in the electronics-computer age and continues to miss out on the concomitant managerial revolution altogether.

The Economy in 1967-69

4. During the past three years the upturn in economic growth experienced in 1964-66 has not been sustained, and the economy has slipped back to the relatively sluggish growth rates characteristic of the early 1960s. Whatever hopes the leadership may have had for regaining the even higher growth rates of the late 1950s have been dissipated. The good harvest last year tended to mask this slowdown, perhaps even to the regime itself. But with the drop in agricultural output this year, the full extent of the economy's retardation is probably obvious to all concerned.

5. Agriculture. The Soviets have been quick to blame the vagaries of the weather for this year's substandard performance in agriculture. There is much truth in this, for the weather to a considerable extent still determines the output of Soviet agriculture

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in any given year. Thus agriculture is the largest single unknown both for Soviet planners in projecting the economy's development and for the top leaders in calculating the country's future resource base. That an uncertainty of this magnitude should still exist in the second half-century of Soviet rule provides a revealing insight into the Kremlin's priorities.

6. There were two unusually poor agricultural years in the first half of the 1960s. These apparently convinced the post-Khrushchev leadership that a substantial injection of resources into agriculture was imperative, and that the long-neglected peasantry required immediate financial benefits and a revised system of incentives. Early in 1965, General Secretary Brezhnev promulgated a series of measures to meet these objectives during 1966-70. Record agricultural production in 1966, sustained and even slightly increased in the next two years, led to a virtual emasculation of the Brezhnev program, which is no longer mentioned publicly as a package of proposals associated with the General Secretary's name. In sum, the Kremlin's attention and Soviet resources have been increasingly diverted elsewhere.

7. Industry. A roughly analogous tale can be told for Soviet industry. The rate of increase in production last year fell below the relatively good rates achieved in 1966 and 1967 as well as the

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lackluster average rate of advance of the first half of the decade. A substantial further deterioration so far this year strongly suggests that the rate of increase in industrial output will be one of the lowest on record.

8. These developments have occurred despite the regime's decision to extend its industrial reform throughout all of industry. The reform called for a reorganization of Soviet industrial management during 1966-68 designed to pressure plant directors into more efficient productive practices and to instill a greater sense of participation and discipline in the labor force. Both objectives, however, were to be realized without abandoning the practice of dictating output targets and the allocation of resources from the center. These practices, together with bureaucratic opposition and the erosion of vigorous regime support, effectively vitiated the reform movement after it had brought about a few one-time improvements, largely in 1966-67.

9. Defense and Space. Although defense spending is estimated to have held fairly steady during 1962-65, it has since been increasing at the fastest rate recorded in any four-year period since the war. It is true that with the continued growth

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of the Soviet economy, spending for the military and space has dropped from 15 percent of gross national product in 1952 to about half that figure today. But the nature of defense spending has changed drastically since 1950, so that it diverts an ever-growing share of industrial output from growth-oriented investment programs, and preempts the best managerial, scientific, and engineering manpower. The effect of this increase is accentuated by the virtual isolation of this effort from the civilian economy.

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10. Quantitatively, the siphoning off of substantial resources by the defense establishment can only have been to the detriment of the civilian sectors in an economy with as little slack as the USSR's. The only part of Soviet industry to have consistently performed well recently has been the machinery sector, which produces the bulk of military equipment as well as capital goods and consumer durables. This achievement highlights the continuing strong demand of the military-space establishment for the economy's resources and the regime's approval of substantial levies to meet this demand. Military-space production, furthermore, entails additional costs not normally encountered in civilian production. Research expenditures must be higher to insure against technological obsolescence in the defense

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industries and extra expenses are required to maintain stand-by facilities deemed essential in a crisis situation.

11. It is estimated that fully three-fourths of Soviet R & D is to meet military-space requirements; the US spends about the same absolute amount, but it represents only 60 percent of the total. In addition, the R & D component of defense spending has been the fastest growing segment of Soviet military expenditures in the 1960s; this year it will probably be half again as large as in 1965. The effects of this drain, moreover, will continue essentially unchanged in the foreseeable future because the USSR can be expected to maintain a substantial military R & D effort even in the event of an arms control agreement.

12. Consumption. Along with defense spending, consumption has continued to rise at a relatively rapid rate. Early in their rule, the post-Khrushchev leaders apparently agreed to continue their predecessor's policy of according greater attention to consumption, in order to increase labor productivity and thereby help achieve more of the regime's goals. The population's standard of living was to be raised by boosting disposable incomes and by increasing the supply of consumer goods and services.

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13. Although there has been appreciable forward movement on both fronts since 1965, Moscow has been more successful in expanding purchasing power than in providing acceptable goods and services in sufficient amounts. As a result, savings deposits have grown dramatically during the past few years. These funds, which are a measure of suppressed inflationary pressures, reflect saving for major purchases, such as cars and appliances, and the growing unwillingness of much of the population to buy the array of goods and services currently available, whose quality often leaves much to be desired. Thus it is probably fair to say that although on an absolute scale the Soviet population is better off than ever before, the positive effects on incentives of recent increases in incomes have been diluted.

14. Investment. In recent years, the USSR has slighted investment in producer goods, which have the greatest impact on economic growth, while fostering an expansion of investment for defense and consumption. Since 1964, the rates of growth of investment in consumer-oriented plant and equipment (mainly agriculture and housing) have increased to nearly twice those for producer goods; growth rates for the latter have fallen below the unusually low figures of the early 1960s. In sum, the shift in

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the pattern of resource allocation has had an adverse effect on the investment which embodies most of the potential for future gains in output.

Problems of Productivity and Efficiency

15. Nevertheless, growth-oriented investment has continued to increase, and the regime still pours very substantial resources into capital assets. By the end of the decade, however, the rate of growth of the economy was less than in 1964-66. In other words, the productivity of the economy, and in particular the efficiency of investment, continued to decline. This decline is rooted in problems of technology and efficiency, which promise to be intractable; they cannot be solved merely by reallocating greater resources to producer-oriented investment. Indeed, they may defy solution within the parameters by the Stalinist economic model.

16. The Stalinist model, with its emphasis on a simple set of priorities, forced draft industrialization, and a rapid growth in the stock of plant and equipment, has become increasingly irrelevant to the operation of a modern economy. It worked well enough when the economy was less sophisticated and the USSR could readily profit by borrowing easily available western

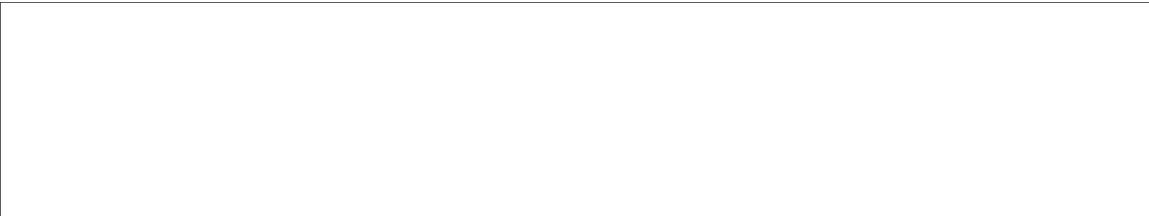
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technology. This situation no longer obtains in an era of increased complexity and sophistication of design concepts that demand imaginative managers responsive to the imperatives of technological progress, and a set of incentives that will promote economic modernization.

17. Technological and managerial developments, particularly abroad, have provided the Soviets with substantial opportunities for extending the frontiers and mainsprings of economic growth; the essence of the USSR's problem is that it has not been able to assimilate them efficiently. The mentality and intellectual horizons of the present leadership, moreover, are imbedded in a now-antiquated framework, which limits the ability of the regime to face up to its fundamental economic problems, much less to solve them. Even so, Moscow probably recognizes that the burgeoning and interrelated problems of technology, management, and incentives must be confronted eventually.

18. Technology. The widening of the technological gap between the USSR and the developed West (including Japan) has been well documented elsewhere.* There are several major



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reasons for the USSR's continuing poor performance in this field. Despite the unquestioned postwar advances in Soviet education, the USSR is still well behind the West in many key areas, both in terms of number of graduates and the versatility of their training. Similarly, Soviet expenditures on R & D do not compare with those of the US. The addition of the Free World's other technologically advanced powers on the one hand, and the Soviet Union's client states in Eastern Europe on the other, tips the balance even further against the USSR.

19. As noted above, the Soviets devote a larger share of their R & D to military-space programs than does the US. (Japan allocates almost 100 percent to the civilian sectors.) But it is important to note that secrecy in the USSR effectively prevents the diffusion of military-sponsored technological progress into crucial civilian sectors, and that the influence and leverage of potential civilian users of defense R & D is in any event quite limited. The Soviet emphasis on research as against development also reinforces the bureaucratic resistance to innovation that is inherent in the Stalinist system. Finally, the industrial reform as it is presently configured offers little prospect for narrowing the technological gap through initiatives at the plant level.

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20. Management. The regressive nature of the Soviet system of management inhibits the application of the technology which does become available to the civilian sectors. As the electronics-computer age relentlessly advances in all developed nations, Soviet administrators are increasingly ill-suited to cope with the multitude of problems and possibilities inherent in the new technology. The vast majority of Soviet plant directors and other top managers are engineers by training whose formative work experience often dates back to the Stalin period; in this they reflect the mentality of the present Kremlin leadership, most of whom have a similar background. Such men tend to be dictatorial, abusive of their employees but servile before their superiors; whatever ingenuity they possess usually is concentrated in circumventing the endemic deficiencies of the USSR's cumbersome systems of supply and distribution.

21. Broadly speaking, the Soviets lack the concepts of modern managerial methods, in large part because these techniques and procedures are so alien to the centralized command administration characteristic of the Soviet economy. Moreover, the stimulus to venture into this territory, like most progressive incentives in the Soviet economy, is no match for the pressures to stick with the tried and time-worn that are part and parcel of the Stalinist economic model.

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22. Incentives. The considerable shortcomings of the dominant incentives operative in the Soviet economy are the obverse of their strengths at earlier stages of the USSR's economic development. Plant directors and their staffs still respond primarily to a set of stimuli which stress production in volume at the expense of quality, variety, and concern for the welfare of their labor force. Quality of output, consumer satisfaction and service are far down on their scale of values. This is not an environment that encourages innovation, entrepreneurship and the willingness to accept responsibility.

Prospects and Implications

23. Despite its deficiencies, there is no question that the Soviet economy has been able to produce a range of goods and services in amounts sufficient to meet the leaders' most urgent needs. That it has done so year in and year out by means of a basically unchanging system must provide a considerable degree of satisfaction to a regime that probably is reluctant to entertain alternative ways for organizing the economy. Yet the Kremlin is clearly unhappy with certain areas of the economy's performance and is becoming increasingly aware of the interrelated problems of technology, management, and incentives. It is

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doubtful, however, that the pressures for change will be strong enough to force the corresponding decisions in the near future.

24. Just as these problems were becoming more acute, moreover, the Kremlin was forced to deal with continuing, top-priority political questions, which were largely forced upon the regime -- the Middle East war in 1967, Czechoslovakia last year, and now China, to mention only the most pressing. Internally, Moscow has chosen to handle its several political problems, ranging from intellectual dissidence to nationality unrest, through the familiar tactic of repression. In this context it comes as no surprise that the regime has permitted so little discussion of further reforms to bring about major improvements in efficiency.

25. Viewed from the Kremlin, such reforms must appear to have inescapably radical political consequences. Moscow's dilemma is that the necessary measures must be substantial if they are to be economically effective -- so substantial as to reach to the very heart of Communist polity and the role of the Communist Party. Their adoption would almost certainly require that the party relinquish most of its present economic functions.

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It would also lead to a far sharper separation between the political apparatus and the economic establishment than at present, with all that this connotes in terms of new types of leaders, new methods of governing, and new forms of control. Such a prospect can only terrify the present leaders, for it raises the question of the extent to which a Communist state can be economically progressive and still remain Communist. Thus, there is more than a suggestion that there are indeed rigorous, built-in limitations on the potentialities for modern economic development within the Communist framework.

26. It is more likely that the regime will attempt to tinker within the framework of the Stalinist model than to undertake any radical experimentation, at least in the short run. If indeed the Soviets are unable or unwilling to modernize their economic system except in this piecemeal fashion and over a long period, the eventual implications are likely to be substantial and to extend well beyond the strictly economic sphere. The rate of Soviet economic growth may continue to decline, and in any event the absolute gap in the size of the US and Soviet economies will continue to widen. This is not to say that the Soviet economy will be jeopardized by disabling fissures or that a continuing high level of defense-space expenditures will be endangered. But the

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Kremlin will have to continue bearing the risks implicit in the present strains and to sacrifice progress toward achieving long-promised economic goals. Further, the visible satisfaction of rising expectations elsewhere will be noted increasingly in the USSR, stimulating pressures from technocrats for advanced productive methods and demands from consumers for more and better goods and services. The difference in the quality of these goods and services relative to western standards will keep on growing.

27. The leadership's handling of these issues almost certainly will add a further dimension to the political maneuvering and infighting that is constantly taking place in the Kremlin. Thus far there apparently have been only skirmishes on these questions, as the regime's longer-range economic concerns of the moment center on spelling out the basic resource allocation patterns of the next five-year plan (1971-1975) within the Stalinist framework. The few measures relating to economic modernization that have been adopted during the past several years have been largely administrative in character and ineffectual in their application. How successive leaders address themselves to the more fundamental questions will be crucial, although it probably is too early to speculate meaningfully on the

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alignment of individuals or groups. On balance, it appears that most of the leaders of the future that can now be discerned are not much more open-minded on these issues than the men now in power.

28. Economic modernization also promises increasingly to be a divisive force in the USSR's relations with the countries of Eastern Europe. Their smaller, less autarkic economies and their greater dependence on foreign trade make the adoption of more efficient economic methods more urgent than in the USSR. The attraction in these countries of liberal economic reform -- regarded as politically subversive by Moscow -- can be expected to persist, especially as they strive to make their exports more competitive in western markets. In particular, as long as Yugoslavia succeeds in its present course of decentralization and economic relations with the West, its example will remain influential throughout the area.

29. The basic question of the nature and durability of Moscow's overall ties with Eastern Europe probably will become more acerbic in the future. Recent trends in Soviet-East European trade, furthermore, indicate a growing economic isolation of the

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socialist camp despite strenuous efforts by both partners to increase their trade with the developed West. Through its technologically advanced exports, the West can provide a direct contribution to modernization in both the USSR and Eastern Europe, particularly in conjunction with the credits that have been offered by certain West European countries. The Soviets, however, have effectively foreclosed on these possibilities, both for themselves and the East Europeans, an action that perpetuates the technological gap and reinforces the Soviet partnership with Eastern Europe. The Kremlin has chosen to bear the resulting economic costs and political strains in order to postpone the radical changes that eventually will have to be made, although procrastination promises to make the final adjustment increasingly harsh, perhaps explosive.

30. Finally, there are world-wide political implications should the Soviet economy continue to lag behind. In the underdeveloped world, the credibility of the Soviet model will suffer increasingly, especially when weighted by its costs in human terms. In Communist circles, the Soviet reputation will decline, particularly under the attacks that the Chinese and their followers can be expected to maintain. Over the longer term, the Kremlin's

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temporizing implies that the period of fundamental realignment, should it arrive, will be profound in its political ramifications.

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